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Viewing cable 09KYIV2140, DPM NEMYRIA'S CASE FOR UKRAINE IMF TRANCHE

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Reference ID	Created	Released	Classification	Origin
09KYIV2140	2009-12-16 13:24	2011-08-30 01:44	CONFIDENTIAL	Embassy Kyiv

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C O N F I D E N T I A L SECTION 01 OF 04 KYIV 002140

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SUBJECT: DPM NEMYRIA'S CASE FOR UKRAINE IMF TRANCHE

REF: A. KYIV 2133
 B. KYIV 2102
 C. KYIV 1982

Classified By: Ambassador John F. Tefft for Reasons 1.4 (b) and (d)

¶1. (C) Summary. Deputy Prime Minister Nemyria made a strong pitch to the Ambassador for the disbursement of a fourth IMF loan tranche to Ukraine. He talked of unreasonable IMF demands for the passage of a 2010 budget, explained why the central bank could not monetize for budget and gas payments, and projected that a Ukraine meltdown would have spillover effects for the region. Nemyria admitted that Prime Minister Tymoshenko's presidential campaign had been damaged by President Yushchenko, whose efforts had worked to "demobilize" and fragment "post-orange" voters. Nemyria is currently en route to Washington with key advisors for emergency follow-up meetings with the IMF. End summary.

MORE FREQUENT FLIER MILES

¶2. (C) In a December 15 meeting with the Ambassador, Nemyria revealed his talking points for December 17 and 18 meetings with senior IMF officials. Nemyria heads back to Washington only ten days after talks with IMF Managing Director Dominique Strauss-Kahn, and less than a week since Foreign Minister Poroshenko saw IMF Deputy Managing Director Lipsky. The follow-up trip was apparently prompted by Prime Minister Tymoshenko's December 14 call with Strauss-Kahn, who allegedly expressed his openness to ongoing negotiations with Ukrainian authorities. Nemyria will be accompanied by acting Finance Minister Ihor Umanskiy, Deputy Finance Minister (and budget expert) Anatoliy Myarkovksiy, and economic advisor Mariia Nikitova.

GOU HONING ITS POSITION

¶3. (C) Nemyria tipped his hand by reviewing the GOU's revised negotiating position. Tymoshenko wanted to make the case that passage of a 2010 budget was not a reasonable conditionality. Pre-election "political fragmentation" had meant that there was almost no chance a budget could be reviewed and adopted in the Rada (Ukraine's parliament) before March or April. Furthermore, even if the budget were reviewed, revised, and adopted on multiple readings (ref C), President Yushchenko would again spite Tymoshenko and veto the bill.

¶4. (C) The fact that the Prime Minister, the Ministry of Finance, and the National Bank of Ukraine (NBU) had signed the IMF Letter of Intent (LOI) was the best possible sign of cooperation, Nemyria argued (ref B). It was clear the President would not sign the LOI for political reasons (the lack of an IMF program harms Tymoshenko's candidacy). Therefore, there was a need to "de-politicize" the IMF process, the Deputy Prime Minister said.

¶5. (C) The GOU would propose to the IMF that the Ministry of Finance and the NBU jointly sign a second LOI, with the PM providing a side letter to give her assurance that she would propose a budget in line with the IMF's expectations after the election. The GOU would also argue that the lack of a 2010 budget was not harmful. Having a continuing resolution-type budget in 2010 would act as a "straight-jacket" on the GOU for at least three months (i.e. until after the inauguration). Any budget passed by the Rada before the election would be populist and bloated, Nemyria stated.

¶6. (C) Tymoshenko and her cabinet were concerned that the IMF's Lipsky and staff-level "mathematicians" failed to see their point. Lipsky had insisted in his meeting with Foreign Minister Poroshenko that the 2010 budget be passed. IMF staff had been allowed to "dictate the pace of the program", especially over whether budget passage should be a lynchpin requirement. Timing was crucial, and the IMF board needed to be convinced quickly. Ukraine was willing to "compromise" and accept a partial \$2 billion tranche (instead of the full \$3.8 billion).

¶ 7. (C) In addition to political reasons preventing the NBU from purchasing GOU securities to pay Gazprom or meet budget obligations (ref B), Nemyria pointed to other factors that militated against monetization. 1) He said it was "against the law" for the NBU to finance the government deficit. 2) He claimed the NBU could not provide funds to the government via commercial banks, since auditors would not be able to approve such transactions. Nemyria noted that this argument had been used in July by Yushchenko, when the President rejected the IMF's suggestion that the NBU monetize GOU securities to make gas payments. 3) Nemyria claimed monetization could lead to interest rates of 50-60%, such as in Russia and Ukraine during the late 1990s. He said Tymoshenko had been firm with Strauss-Kahn on December 14 when she noted that monetization was not an option.

¶ 8. (C) Note: The first point above was mentioned by Nemyria and Poroshenko to the IMF last week. Nonetheless, while legislation governing the powers of the NBU bans direct lending to the GOU to finance the budget deficit, it does not forbid the NBU from buying government treasury bills. According to NBU official figures, the central bank purchased UAH 27.7 billion in domestic treasury bills during the first nine months of 2009. The IMF estimates the NBU has room to print billions more, while holding enough reserves to protect movement in the exchange rate. On the second point above, according to Ukrainian legislation, loans to any one borrower should not exceed 25% of a bank's capital. However, state-owned Oshchadbank, the government's chief conduit for monetization, has 53% of its loan portfolio booked with Naftohaz, a sum roughly equal to 120% of its capital. A bigger problem with domestic debt issuance to commercial banks is that it crowds out other investment, given that t-bill yields now exceed 24-25%. On the third point above, the 2009 situation is qualitatively different from the 1990s. Inflation this year will not reach higher than 15%, and Ukraine's overall sovereign debt burden remains relatively modest. End note.

OUTREACH GONE GLOBAL

¶ 9. (C) Nemyria reported that Russia and Brazil had requested an informal December 15 brief on Ukraine from the IMF board. Strauss-Kahn told Tymoshenko that he had separately asked for a brief from IMF executive directors and had planned to hold sessions with the European, BRIC, and Nordic-Baltic groups on Ukraine's behalf. The Deputy Prime Minister told the Ambassador that he had recently met with the French, German, and Chinese ambassadors. (Note: Key ally ambassadors commented to the Ambassador on December 15 that they thought both the Russians and the Chinese had been weighing in heavily with the IMF. End note.)

¶ 10. (C) Nemyria reported that the German IMF executive director had been the most cautious vis-a-vis emergency lending to Ukraine. However, on the margins of the European Peoples' Party congress in Bonn last week, Tymoshenko apparently had been told by Chancellor Merkel that the German Ministry of Finance planned to send updated instructions to its representatives in Washington. Similarly, the French Finance Ministry would send new instructions to its IMF executive director, Nemyria told the Ambassador. (Note: Our German embassy contacts told us on December 16 that Berlin did not plan to back down from their firm approach to Ukraine's IMF program. End note.)

IMF SDR ALLOCATIONS NOT ENOUGH

¶ 11. (C) Nemyria said that allocations of IMF Special Drawing Rights (SDR) were nearly depleted. Most of the SDR allocations had been used for gas and external payments. According to the Deputy Prime Minister, the GOU had just incurred an additional foreign currency obligation as a condition of debt restructuring talks over a loan default by Ukrzaliznytsa, the state railway company. The GOU would need

to pay an unspecified amount from the remaining SDRs to Ukrzaliznytsa's creditors on December 29, Nemyria said.
(Note: We heard separately from Deputy Minister of Finance Myarkovskiy that Ukraine had UAH 1.77 billion (\$221 million) in SDRs remaining. Nemyria made no mention of the GOU's use of SDRs for November budget payments. Nemyria economic advisor Nikitova admitted to us that SDRs were reported as November revenue for IMF budget deficit calculations. End note.)

¶12. (C) The Deputy Prime Minister assured the Ambassador that gas prices for household consumers would increase by 25% in April 2010. This figure was enough to make up lost revenue from the Prime Minister's cancelled increases in September, a move that breached one of the IMF's core demands, argued Nemyria. Naftohaz executives were meeting on December 15 over whether to buy more gas in December, rather than wait until 2010 when prices will be higher. Nemyria believed that if Naftohaz bought 5.5 billion cubic meters (BCM) in December (for about \$1.2 billion), it would not need to purchase as much in Q1 2010. (Note: Naftohaz spokesman Valentyn Zemlyansky told us on December 15 that Naftohaz planned to take roughly 5.5 BCM and would make the payment for December gas purchases, due January 7, by the end of the month. End note.)

¶13. (C) If it came down to making tough spending choices, Tymoshenko would opt to contain possible social unrest, according to Nemyria. The top item on her crisis agenda was making wage and pension payments, the second was meeting Ukraine's monthly bill to Gazprom, and the third was all remaining budget obligations, including payment of large and growing VAT refund arrears. In response to the Ambassador's questions, Nemyria commented that Ukraine needed more stability before refunding VAT to exporters, though he noted some SDRs had been used for that purpose in recent weeks.

DIM PROSPECTS WITHOUT IMF

¶14. (C) Nemyria concluded his review of Ukraine's position on the IMF by stating that the Fund program had been a success thus far. Ukraine's economy had stabilized; the run on bank deposits had been stopped. But speculative, short-term capital could flee from Ukraine at any time, and parent banks were poised to pull stakes if things got too far off track with the IMF, Nemyria added.

¶15. (C) The Deputy Prime Minister commented that his recent media interviews were neither "blackmail" nor "soft blackmail", as critics suggested (ref A). IMF staff simply had not paid enough attention to the potential strategic consequences of Ukraine's economy unraveling. There would be a spillover to the region, Nemyria noted, especially affecting fragile economies like neighboring Hungary. Any strategic opportunity for reforming Ukraine after the presidential election would be lost.

TYMOSHENKO'S ELECTION CHANCES

¶16. (C) The presidential election was now a contest between Tymoshenko and opposition Party of Regions leader Viktor Yanukovych. There was no longer "any talk of a third candidate" (i.e. Arseniy Yatsenyuk). Yanukovych had an impressive lead of 7-10%; he would likely preserve this margin through the first round of balloting on January 17. Nemyria commented that Yanukovych's core was solid but his projected 2nd round support of 42% would be 6% less than in ¶2004.

¶17. (C) The biggest concerns for Tymoshenko were the fragmentation and "demobilization" of the "post-orange" electorate. Pro-European voters had split their allegiances among a number of Ukraine's eighteen candidates, though in aggregate they added up to more votes than Yanukovych could expect to receive. The key was to attract those voters between the first and second rounds, while eroding

Yanukovych's base in the east.

¶18. (C) President Yushchenko's criticism had hurt Tymoshenko, especially his stroking of nationalist sentiment with such statements as "she's selling Ukraine to the Russians" or "she's on par with Yanukovych" or "she's never been a Ukrainian patriot". Tymoshenko had made a decision not to respond, but it was "really damaging". Yushchenko was attempting to discourage support for Tymoshenko in the west, a de facto policy of supporting Yanukovych.

¶19. (C) Nemyria said he did not expect large-scale voting irregularities such as in 2004, but he speculated there could be attempts to manipulate final tallies. He praised the idea of Georgia sending observers to Donetsk oblast, one result of Tymoshenko's unpublicized meeting with Georgian President Saakashvili in Bonn last week.

PRESENTING TYMOSHENKO'S EURO-ATLANTIC CREDENTIALS

¶20. (C) Nemyria presented Tymoshenko as the obvious choice in a "black and white" race. He pointed to the fact that Yanukovych would recognize South Ossetia and Abkhazia (he had twice announced his intention to do so). The Prime Minister wanted to continue NATO integration, but she took seriously the fact that NATO was a divisive issue. Tymoshenko estimated that 23-25% of Ukraine's population supported Ukrainian membership, a figure far below Yushchenko's oft-mentioned claims of 33%, especially since the Georgia conflict. A final decision on NATO would be left to a referendum, according to Nemyria. In any case, Ukraine was willing to continue taking an active role in humanitarian and peacekeeping operations with Euro-Atlantic partners.

COMMENT

¶21. (C) Nemyria's points on the budget have validity if seen through a narrow lens. It is likely true, for instance, that any 2010 budget passed before the election would be rife with populist pork. However, it is not clear that NBU Governor Stelmakh would be willing to sign a follow-up LOI with just the Ministry of Finance. Similarly, it does not necessarily follow that a continuing resolution-type budget would be a fiscal "straight-jacket", given the fact that it allows for discretionary spending without specific line items. Furthermore, we agree with the IMF that not only can monetization happen via t-bill issuances to finance gas purchases (and/or short-term wage and pension payments), there would not necessarily be a major inflationary or exchange rate effect. Nemyria's finance team will have to make more poignant explanations to Washington interlocutors to overcome these concerns.

TEFFT